CITY OF SAN JOSÉ, CALIFORNIA
800 N. First Street • San Jose, California 95112 • Tel: (408) 277-4601
GERALD A. SILVA
City Auditor

March 20, 1998

Honorable Mayor and
Members of the City Council
801 North First Street
San Jose CA 95110

Transmitted herewith is the City Auditor's analysis of the Environmental Services Department's (ESD) February 19, 1998 memorandum on the evaluation of a lease of the San Jose Municipal Water System (SJMWS).

Based on our analysis of the ESD's memorandum, we have concluded the following:

1. On balance the estimated financial benefits of leasing the SJMWS do justify pursuing this alternative.
2. The obstacles to leasing the SJMWS that the ESD identified appear to be surmountable.
3. Identified concerns such as water system rates, system maintenance, and other operating issues can be mitigated by carefully crafting an RFP for leasing the SJMWS.
4. Discussions with the United States Department of Interior may resolve certain issues regarding Hetch Hetchy water.
5. By retaining the rights to Santa Clara Valley Water District (SCVWD) water during the term of a lease of the SJMWS, the City can preserve its rights at the end of a lease and protect the SCVWD's tax exempt bond status.

Accordingly, I recommend that the City initiate discussions with the United States Department of Interior regarding Hetch Hetchy water.

I also recommend that the City proceed with the issuance of an RFP to lease the SJMWS, in order to determine how much, in fact, the City would receive in an arms-length, equitable lease transaction.

I will present this analysis at the March 25, 1998, Finance Committee meeting.

Respectfully submitted,

Gerald A. Silva
City Auditor

GS:bh

cc:	Regina Williams	Carl Mosher	Debra Figone	Lorrie Gervin
	Sherry Langbein	Mansour Nasser	Joan Gallo	Bob Wilson
	Mollie Dent	Dennis Church	Bob Brownstein	John Guthrie

Here are my comments on various statements in the Environmental Services Department's (ESD) February 19, 1998 memorandum on the evaluation of a lease of the San Jose Municipal Water System (SJMWS). Specific statements made in the ESD's memorandum are reproduced below followed by my comments on those statements.

Environmental Services Department Memorandum

Page 5, paragraph 5:

> *Both executed leases considered in our analysis (Hawthorne and Cupertino) involved substantial rate increases -- either agreed upon in advance or shortly after a lease was executed.*

Page B-3, paragraph 4:

Both the Hawthorne and Cupertino leases involved substantial rate increases, and these increases accounted for a portion of the proceeds in each case.

Page C-2, paragraph 5:

> *Both executed leases considered in our analysis (Hawthorne and Cupertino) involved substantial rate increases--either agreed upon in advance or shortly after a lease was executed.*

City Auditor Comments

Prior to the lease, the City of Cupertino (Cupertino) had in place an inverted rate structure that penalized higher water users in an effort to encourage conservation. San Jose Water Company (SJWC) uses a straight-metered rate. The Cupertino lease provides for SJWC to adjust the rates for its new Cupertino customers to the rates current SJWC Cupertino customers are paying. The lease states that the water rate adjustments are to be phased in over a three-year period. For residential customers, water rates will increase or decrease, depending on water consumption. For the first year, the average Cupertino residential customer's bi-monthly water bill will increase $2.09, or 2.86%. For commercial customers, depending on their meter size and consumption, their water bills will either increase or decrease.

<u>Environmental Services Department Memorandum</u>

<u>Page 7, paragraph 7:</u>

> *"Water supply fixes" refers to costs required to solve problems related to Santa Clara Valley Water District tax exempt bonds, to establishing an alternative retail operator for the Recycled Water System, and to keeping or establishing alternatives to the Hetch-Hetchy water supply . . . .*

<u>City Auditor Comments</u>

Santa Clara Valley Water District:

As stated in the City Attorney's Office memorandum dated February 23, 1998, bond counsel for Santa Clara Valley Water District (SCVWD) stated that an analysis needs to be performed that shows the following information

> *. . . the District facilities used to supply water to the City; the outstanding tax exempt debt associated with those facilities; the ratio of existing public versus private use of those facilities; and the likely ratio of future public versus private use if new facilities were to be needed and financed with tax exempt bonds. The **District Board would** then review the study to **determine whether to consent to a lease which includes an assignment of the City's water supply rights**.*

Based on a review of the Cupertino lease and discussions with SJWC personnel, Cupertino did not assign its SCVWD water rights to SJWC. The only change that occurred is that SCVWD sends the invoice for water purchased to SJWC instead of Cupertino. With this structure, should Cupertino resume management of the water system at the end of the lease, its entitlement to water will be intact. Based on this information, it appears that it would be in the City's best interest to also not assign its SCVWD water rights to a lessee to avoid any potential issues with SCVWD's tax-exempt bond status and preserve the City's rights to SCVWD water at the end of the lease.

South Bay Water Recycling System (SBWR):

As stated in the City Attorney's Office memorandum dated February 23, 1998

> *. . . if the Municipal Water System is leased, but SBWR is not, the Plant would have responsibility for operations and maintenance of the SBWR facilities, unless it entered into an agreement with a third party to pay for operation and maintenance of these facilities. Present plans call for the Municipal Water System to receive funding from the Treatment Plant Operating Fund for operations and maintenance of the SBWR facilities located in the Municipal Water System service area.*

Based on this information, the Treatment Plant Operating Fund will pay the cost to maintain the SBWR facilities whether it is the SJMWS performing the maintenance or someone else.

Hetch Hetchy Water Supply:

The SJMWS staff received a letter from the City and County of San Francisco Public Utilities Commission (SFPUC) regarding the Hetch Hetchy water supply. This letter stated the following

> (San Francisco) *would seek the advance approval of the Department of the Interior before consenting to any arrangement involving the operation or management of San Jose's water system by a private entity for profit, irrespective of whether local supplies could meet the needs of Cal Water and San Jose.* <u>*It may be possible to structure a lease or other transaction to obtain federal approval if San Jose does not give up control of the water delivered.*</u>
>
> <u>*If the Department of Interior consented to the arrangement, the SFPUC's* (San Francisco Public Utilities Commission) *consent would not be required for a transfer or assignment of rights to another entity consistent with section 7.06 of the Master Agreement.*</u> (Emphasis added)

It appears that by retaining control of the water received, the City could resolve an important Hetch Hetchy water supply issue without expending much in the way of funds or effort.

We recommend that the City initiate discussions with the United States Department of Interior regarding Hetch Hetchy water.

<u>**Environmental Services Department Memorandum**</u>

<u>Page 9, paragraph 4:</u>

> *How much effort should be made to ensure that customer rates are as low as possible consistent with the lease agreement terms?*

City Auditor Comments

The City could address this issue in the RFP process by stipulating specific parameters with regard to customer rates. Further, the RFP could stipulate that the City Council would retain the right to approve any customer rate increases over the life of the lease.

Environmental Services Department Memorandum

Page 9, paragraph 8:

> *Is it fair to lease the system without paying off the bonds? Is it prudent?*

Page 14, paragraph 2:

> *. . . Should the capital value of the System be extracted and used for other purposes while the indebtedness which created that value remains a burden to property owners in the System service area? The Administration believes that the answer is no. If the System is leased, we would recommend that proceeds from the lease should first be used to pay off the bonds and relieve the property owners of their remaining outstanding debt.*

City Auditor Comments

What needs to be considered is the fact that some people in the assessment district area have paid off their assessment or chose to finance it with the purchase price of their house. It would be unfair to those people to pay off the current indebtedness. If the choice of certain property owners in the assessment district areas was to take advantage of paying for the improvements through assessments, they should be responsible for paying for what they owe and for the service they will continue to receive.

In a February 23, 1998 memorandum, the City Attorney's Office stated that in order to preserve the tax-exempt status of the assessment district financing, four actions are allowed by the IRS. Of the four options, the one that obviates the need to pay off the $10 million in bonds is *"Expenditure for an alternative use."* The memorandum describes this action

> *It is also possible to expend a sum of money equal to the fair rental value of the bond financed assets (referred to as the "Disposition Proceeds") for a "Qualified Alternative Use". This, in effect, "recycles" the bond proceeds. The Disposition Proceeds will be the amount of the outstanding bonds as long as the present cash value of all payments to be made to the City under the terms of the lease. . . exceeds the amount of the outstanding bonds. A Qualified Alternative Use would be the acquisition, construction or rehabilitation of City owned facilities.*

Accordingly, the City would not have to pay off the $10 million in bonds so long as $10 million of lease proceeds were used to acquire, construct, or rehabilitate City owned facilities. Given that this is a very likely use of lease proceeds (see page 8 of this memorandum), it would be sheer folly for the City to spend $10 million to pay off bonds unless it absolutely had to do so.

Environmental Services Department Memorandum

Page 10, paragraph 5:

Unless the Hetch-Hetchy supply is maintained and the City converts to permanent status, $8 million in new capital facilities could be required (new supply connections and wells).

City Auditor Comments

In the Major Water Facilities Fee report dated April 15, 1996, the following statement is made

The present Alviso/North San Jose water source (Hetch Hetchy) is defined as temporary and interruptible by the San Francisco Water District (SFWD). An additional permanent source of supply other than groundwater, must be developed.

The projects in the Major Water Facilities Fee report that appear to be related to this statement total approximately $6,000,000. Funding for these projects is 68.8% from the major water facility fee and 31.2% from water rates. When we looked back to the master plan prepared in 1990, the same amount was noted for the same projects. Based on this information, it appears that the SJMWS has been planning for some time to install the necessary facilities to connect the Alviso/North San Jose service area to the Santa Clara Valley Water District supply if permanent Hetch Hetchy status is not achieved.

Environmental Services Department Memorandum

Page 14, paragraph 5:

Compared to the $51 million to $61 million net present value of keeping the system under City management, leasing the system is simply not financially attractive. The net present value range of $51 million to $61 million is the discounted sum of more than $150 million in total annual General Fund transfers by the Municipal Water System over 40 years. To give this up for a net of $30 million does not make economic sense. Or said most directly, a lease would involve giving up at least $51 million to gain about $30 million. This would be, by anyone's accounting, a loss to the City.

Page C-3, paragraph 6:

> *Our analysis assumes that a shorter lease would tend, all other things being equal, to have less value because there would be less time in which to generate net income for the lessee. Our analysis assumed a 40-year lease for two reasons. First, our sale analysis conveyed to the Council in 1996 used a 40 year time horizon to project numbers, and using the same period in this analysis facilitated an apples-to-apples comparison with the values generated in the sale study concerning the net present value of transfers to the General Fund under continued City management.*
>
> *The second reason to use a 40 year lease term for analysis is to present a best case total lease payment estimate.*

City Auditor Comments

We strongly disagree that *" . . . a lease would involve giving up at least $51 million to gain about $30 million."* Specifically, the ESD calculated the $51 million the City would give up if it leased the SJMWS by discounting the sum of General Fund transfers over forty years. As discussed below, we do not feel a forty-year lease term is appropriate. Given the fact that the two leases currently in California are fifteen and twenty-five years, we feel a twenty-year lease is more reasonable. Based on this, we calculated the discounted cash flow for twenty years from the cash flow information the ESD generated. The discounted cash flow for twenty years is approximately $36 million not the $51 million for forty years that the ESD showed above. Additionally, the ESD calculated its $30 million estimate of lease proceeds as follows:

Total Lease Payments	$50 Million
Less:	
Assessment District Bond Pay-Off	$10 Million
Cost To Monitor The Lease	$10 Million
Net Lease Proceeds	$30 Million

We believe the net lease proceeds would be more than $30 million because: 1) the City should not and would not pay off $10 million in assessment district bonds (see page 4 of this memorandum), 2) the costs to monitor the lease are significantly less than $10 million (see page 11 of this memorandum), and 3) the ESD ignores the SJMWS' $10 million in cash and investments that would become available for other City purposes should the City lease the SJMWS.

Accordingly, we believe a lease would net the City about $50 million calculated as follows:

Up-Front Lease Payments	$40 Million
SJMWS Cash and Investments	$10 Million
Net Lease Proceeds	$50 Million

As noted above, it is not clear why the ESD chose a 40-year lease life for its analysis of leasing the SJMWS. The two leases of water systems currently in California involve fifteen and twenty-five year lease terms, which is vastly different than forty years. Given that there is no precedent for a forty-year lease, the ESD's cost/benefit analysis is fatally flawed and appears to be clearly biased against a lease arrangement.

The ESD's assumption that a 40-year lease presents a *" . . . best case total lease payment estimate."* is unsupportable for the following reasons

– The only examples of long-term contracts cited in the ESD's memorandum refer to pricing agreements or franchise agreements that have no relation to a lease arrangement.

– If you more properly assume that the City would only lease the SJMWS for twenty years and then lease it again for another twenty years any cost/benefit analysis would clearly favor leasing. Specifically, in twenty years the City would be able to receive another significant up-front payment from a lessee. It is difficult to speculate on how much a lessee would pay for the right to lease the SJMWS for a second twenty-year period. However, given the growth that the SJMWS will experience and inflation, <u>the City could easily receive another up-front payment of $60 million to re-lease the SJMWS twenty years from now.</u>

– The ESD ignores the potential for annual lease payments and possessory interest taxes the lessee could or would pay to the City's General Fund. Over the term of a twenty-year lease, these payments could amount to several hundred thousand dollars a year or more.

Additionally, it should be noted, that on April 1, 1996, the Administration issued a report entitled, <u>Infrastructure Maintenance: Assessment and Policy Review</u>. In this report the Administration stated that *" . . . the annual unfunded maintenance need for our assets is estimated to total over $17* [18] *million, or a 35% increase over current annual maintenance funding."*

The following is a breakdown of the $18 million:

Streets	$11.2
Traffic Operations	1.2
City Buildings	2.4
Bridges	1.0
Sidewalks	.7
Sanitary Sewers	.2
Parks	1.6
Total	$18.3

The Administration also noted that unless action was taken to address the current backlog on maintenance, the City will continue to see the cost of maintenance escalate by as much as 300 percent in some areas. In addition, a backlog exists for information systems of $1.25 million and vehicles/equipment of $8.1 million for a total backlog of over $27 million.

Applying any large infusion of cash, such as the $50 million discussed above, could benefit the City and all of its citizens in two ways. First, identified unfunded infrastructure needs of nearly $30 million could be met. Second, by addressing these unfunded infrastructure needs now the City could save multiples of any dollars spent today. As the Administration noted in its April 1996 report, when it comes to infrastructure needs it is *"pay now or pay a lot more later."*

Deferring $30 million in unfunded infrastructure to a later date could easily cost the City $100 million. Conversely, applying a $30 million cash infusion from leasing the SJMWS toward unfunded infrastructure needs could ultimately save the City $100 million. The City could easily address the nearly $30 million in identified infrastructure needs with the $50 million that could be received if the City leased the SJMWS. Thus by leasing the SJMWS, the City would eliminate the potential of incurring $100 million in lost opportunity costs.

Therefore, in our opinion, the statements, *" . . .a lease would involve giving up at least $51 million to gain about $30 million. This would be, by anyone's accounting, a loss to the City."* should really read *"a lease would involve giving up only $36 million to gain $100 million or more. This would be, by anyone's accounting, a gain to the City."*

Environmental Services Department Memorandum

Page B-2, paragraph 2:

> *In order to assess the prospects for a privatized operation (either a lessee or a management contractor) to achieve efficiency savings greater than the City could achieve, the Municipal Water System's efficiency was compared with the estimated efficiency of Class A investor-owned water utilities. The results, as set forth in Table #1, show that the Municipal Water System is already quite efficient. There is no reason to assume that lease or contract operation could achieve greater efficiencies than could the City itself.*

City Auditor Comments

We noted that Table #1 has the following footnote:

> *Care must be taken in drawing conclusions from this data. The Municipal Water System contracts out functions, and some functions are performed by other departments and their costs are in the overhead charges. This reduces the Municipal Water System employee count. On the other hand, many of the other utilities in the table have outsourcing contracts and/or parent corporation charges not reflected in their employee counts.*

This paragraph suggests that Table #1 is missing information that could significantly change the calculations and comparisons made. Therefore, there is no reason not to assume that a lease or contract operation could achieve greater efficiencies than could the City itself.

Environmental Services Department Memorandum

Page C-2, paragraph 1:

> *A parsimonious attitude toward rate increases and heavy demands for documentation substantiating rate increase requests, success in the City's efforts to increase water conservation and recycling (as part of the South Bay Action Plan), and limiting development approvals to those consistent with the City's land use goals and policies would all drive down gross revenues. Specific and enforced lease requirements mandating high levels of customer service and system maintenance and proactive lessee efforts to support conservation and recycling would all increase the costs of providing service.*

City Auditor Comments

All of these concerns can be addressed by properly crafting the RFP document.

Environmental Services Department Memorandum

Page C-4, paragraph 3:

> *. . . the Hetch-Hetchy settlement agreement expires in 2009. The long term water future of California is uncertain. Water supply could become a far more important strategic factor for the City in the future.*

City Auditor Comments

Under a lease, the City still retains ownership of the SJMWS, therefore, to the extent the City has a voice in the water community, the City's position remains the same.

Environmental Services Department Memorandum

Page C-4, paragraph 6:

> *The City would likely want to lease the water system as a non-exclusive service area so that it could continue to market recycled water to current and future customers of the potable system. This, especially when combined with lease terms that require the lessee to proactively cooperate and support the growth in recycled water sales, could depress the gross revenues of the lessee by a significant amount. Preliminary estimates are that recycled water sales could depress net revenue by three to five million dollars over the life of the lease.*

Page 4, paragraph 6:

> *While the $34 to $42 million range seems fairly tight and it might appear that this could be a fairly good estimate, we agree with the Auditor and with the water companies that the City will never know for certain what price the market could command without inviting proposals pursuant to a well-defined lease RFP.* (Emphasis added)

City Auditor Comments

The City Auditor's Office completely agrees with the emphasized wording above.

We recommend that the City proceed with the issuance of an RFP to lease the SJMWS, in order to determine how much, in fact, the City would receive in an arms-length, equitable lease transaction.

Environmental Services Department Memorandum

Page C-5, paragraph 2 and 3:

> *It is easy to cut corners on service. Responses to customer inquiries and service requests can be slower. Complaints can be left to linger too long before an adequate response is offered or corrective action is taken. Fixing system problems that effect customer services can take longer. The responsiveness to economic and community development needs can be reduced. Accuracy and reliability in meter reading and billing can drop. The list could go on.*
>
> *None of these things needs to happen as a result of a well crafted lease agreement. However, the only insurance that they won't is to develop specific lease terms and provisions related to the levels and quality of expected customer services. All other things being equal, the enforcement of such standards would add to the cost of providing service and as a result impact the total lease payment.*

Page D-3, paragraph 6:

> *For purposes of this analysis, the City cost to administer the lease contract and to regulate rates during the 40 year term of the lease was estimated to range between $7 million and $11 million in present value.*

City Auditor Comments

The $7 million to $11 million shown above is based upon a 40-year lease. Such an assumption is unrealistic and by definition significantly overstates what the cost to administer a twenty-year lease would be. The ESD's estimated cost to administer a lease also seems excessive when other SJMWS administrative functions are considered. For example, in the past SJMWS has hired a consultant to prepare reports on developing water service connection fees, implement the major water facility fees, and develop and/or revise the water rate structure. From June 1, 1990 to November 17, 1995, the SJMWS spent $248,000 on a consultant to work on the items noted. That calculates to only about $49,000 per year. Further, the City can structure any lease of the SJMWS to address the ESD's concerns about customer service, maintenance of the system, and other operating issues. In our opinion, the ESD's estimated $7 million to $11 million to administer a lease of the SJMWS appears to be based on an absolute worst case scenario with regard to the integrity and competency of the eventual lessee.

Environmental Services Department Memorandum

Page D-3, paragraph 7:

> *Transaction costs could also vary widely, depending on how carefully and thoroughly the process was planned and implemented. Transaction costs were estimated in the Sale Report at $3 million exclusive of election costs. Most all of these same transaction costs would apply in a lease as well.*

City Auditor Comments

The City Auditor's Office 1996 report, *An Evaluation Of the Feasibility Of The City Of San Jose Selling The San Jose Municipal Water System*, includes the following list of estimated transaction costs:

Financial Advisor	$ 100,000
Legal Costs	200,000
Bond Counsel	200,000
Staff Costs	600,000
Call Premium	400,000
Miscellaneous Costs	500,000
Election	1,000,000
Total	**$3,000,000**

Under a lease transaction, the $1 million in election costs are no longer applicable. Further, if the City decided not to pay off the $10 million in special assessment bonds, another $700,000 in costs could be eliminated leaving at most $1.3 million in lease transaction costs.

Conclusion

Based on the above information and comments, I recommend that the City initiate discussions with the United States Department of Interior regarding Hetch Hetchy water. I also recommend that the City proceed with the issuance of an RFP to lease the SJMWS, in order to determine how much, in fact, the City would receive in an arms-length, equitable lease transaction.

If the City does not go forward with the issuance of an RFP, I will address the Administration's memorandum on lease financing at a later date.